EXECUTIVE SECRETARIAT
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Executive Secretary
10/6/83
Date

3637 (10-81)

THE SECRETARY OF THE TREASURY

WASHINGTON, D.C. 20220

October 5, 1983

83-4864

MEMORANDUM FOR THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF DEFENSE
THE ATTORNEY GENERAL
THE SECRETARY OF AGRICULTURE
THE SECRETARY OF COMMERCE
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
DIRECTOR OF CENTRAL INTELLIGENCE
UNITED STATES TRADE REPRESENTATIVE
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ASSISTANT TO THE PRESIDENT FOR CABINET AFFAIRS
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
ASSISTANT TO THE PRESIDENT FOR POLICY DEVELOPMENT

SUBJECT: Senior Interdepartmental Group on International Economic Policy (SIG-IEP)

A meeting of the SIG-IEP is scheduled to be held on Friday, October 7, 1983, at 2:00 p.m., in Room 208, Old Executive Office Building. The agenda is as follows:

1. International Finance Corporation;
2. International Debt Update;
3. Report on IMF/IBRD Annual Meeting; and
4. Export Administration Act.

A background paper on the International Finance Corporation is attached; the remaining agenda topics will be oral reports.

Attendance will be principal, plus one.

DTR

Donald T. Regan

Attachment

International Finance Corporation (IFC)

The following is a brief description and history of the IFC, and a discussion of current issues concerning U.S. partcipation and future programs of the IFC.

Description

The IFC was established in 1956 to supplement the activities of the IBRD by providing financing and investment expertise particularly suited to attracting, and lending confidence to, private sector investors in developing countries. Currently, IFC has capital subscriptions and accumulated earnings of $748 million (compared to the original $110 million). In FY 83, it provided financing totaling $845 million through its own lending and through syndications.

The IFC is designed to further economic development in its developing member countries by promoting and supporting private enterprise. It accomplishes this by bringing together entrepreneuship with both foreign and domestic investment capital for developmental purposes. The Corporation provides and mobilizes funds and is one of the few international organizations which can provide risk capital as well as long-term loans without government guarantees.

Not only are IFC's own funds often critical to a venture's success, but its financial commitment has become increasingly important as a catalyst in attracting other financing. It attracts funds from international capital markets by syndicating loans, and through underwritings and standby financing.

IFC's technical assistance to member countries and project sponsors is equally important in stimulating private capital flows. The bulk of this assistance is project related, consisting of legal, financial and engineering advice to project sponsors going well beyond what private financial institutions would be prepared to provide.

The first twenty years of IFC's existence were characterized by conservative financial practices, as it developed investment experience. During the first five years, IFC lent only $51 million, mostly in manufacturing and processing. From 1961 to 1966, IFC began to make equity investments, and in 1965 the IFC's Articles of Agreement were amended to permit borrowing from the IBRD up to a limit of four times its own capital, which has led to increased emphasis on IFC lending as opposed to equity investment. After twenty years, IFC had reached an annual commitment level of only $245 million while at the same stage of their institutional existence, the IBRD was lending over a billion dollars, and IDA was lending over three billion dollars.

The 1977 Capital Increase

In 1977, the United States was able to push through an IFC Capital Increase as a *quid pro quo* for the large IBRD Selective Capital Increase that Bank management wanted. The subscribed 1977 increase of $480 million included a U.S. share of $112 million, (23%) representing a decline from our previous one third share.

This capital increase significantly changed IFC's approach to development, bringing with it the so-called "dual strategy". Whereas formerly IFC tended to focus its activities in middle income LDCs such as Brazil, Mexico, and the Philippines, where local private sectors were well developed, under the dual strategy it also expanded its activities in the poorest countries in Africa and South Asia. However, IFC recognized that the administrative costs and risks of promoting the private sector in the poorest countries would be high because of their lack of infrastructure, the heavily government-dominated economies, and the shortage of local private capital. Consequently, the second component of the dual strategy was designed to compensate for the high administrative costs. Drawing upon IFC's strength as a financial catalyst, it called for increased investment in large profitable projects (such as development of natural resources); this was also in keeping with the role of the IFC as a catalyst for increased private investment since these were also projects that normally attract large amounts of private capital. IFC's administrative costs and risk per dollar invested were relatively low in these types of projects and its return relatively high -- thereby offsetting the higher cost and risk associated with smaller projects in lower income countries.

Results of the Five Year Program (1979 - 83)

In the Five Year Program that has just ended, IFC was successful in meeting or surpassing its aggregate objectives, particularly in the early years of the program due to its own promotional efforts and favorable worldwide economic conditions. Investments in Africa almost doubled in accordance with the low income focus of the dual strategy. During the Plan, as expected, IFC diversified the sector composition of its activities, shifting away from manufacturing toward agroindustry. However, although net investments doubled, equity investments remained constant because of concern over the low returns and the limited opportunities.

During this Five Year Plan, IFC continued to be an effective financial catalyst. For every dollar invested by IFC for its own account, others invested about six dollars. Unfortunately, although IFC's capital base and scale of operations grew, IFC was not able to increase its profits proportionately; net income remained virtually unchanged, only rising from $19.2 million to $23 million in the period. The dual strategy also had a definite adverse impact on income growth through the Corporation's higher overhead and increased loss reserves. The income position was further exacerbated by the absence of large mineral investment opportunities in higher income areas because of unfavorable economic conditions (particularly depressed commodity prices). In FY 83, the Board of the Corporation approved $845 million in new investments, of which $426 million were for its own account, and $419 million were syndications. Equity investments reached $55 million.

The New Five Year Plan and its Capital Increase

In the fall of 1982, IFC presented a new and ambitious Five Year Plan, which included a $750 million capital increase that Bank President Clausen endorsed at the 1983 Bank/Fund Annual Meetings. (The U.S. share of a possible increase, if maintained at existing 27% share, would require about $200 million over five years, or about $40 million a year from FY 86-90.) The Plan would expand investment at a 12% annual rate in real terms and leverage its financial resources by seven to one. As an innovative departure IFC has proposed creating a fund to pool equity resources from small independent oil companies, commercial financial institutions, and IFC itself ($100 million in equity) for use in oil and gas exploration and development projects in LDCs.

The Plan would also continue IFC's expanded emphasis on Asia (139% increase) and Africa (96% increase). Finally, the Plan proposes a six-fold increase in equity investments and a slight retrenchment in IFC participation in development finance corporations.

Since the presentation of the Plan almost a year ago, there has been little movement. IFC has held two seminars with the Executive Directors, but Board discussion of the proposed plan and capital increase, originally scheduled for October, has now been put off pending completion of an updated proposal, probably toward the end of this calendar year. (It has also been delayed because management has decided to place priority on IDA funding before going forth with other capital increases.) A definitive reaction by major countries has thus far been hampered by other pressing Bank issues; however, indications are that many members are prepared to consider a capital increase for IFC.

Issues

The United States has indicated support for an increase in IFC and its capital base, although we have not given a formal indication of our views on the specifics of the new Five Year Plan or the timing or size of a capital increase. In theory, IFC is the best vehicle to advance the Administration's emphasis on the private sector as the engine for growth in the developing world, as opposed to concessional aid programs. However, several issues about the future direction of the Corporation must be considered in relation to a capital increase.

1. The Dual Strategy. The current reluctance of commercial banks to extend credits to Latin America suggests that IFC, with its excellent financial leverage, could assist by increasing its Latin American activities at a greater rate than currently planned. Shifting the Plan's focus to increase Latin America's share might also improve IFC's net income position because of the greater profitability potential and lower overhead.

2. Degree of Government Participation in IFC Projects. In FY 81, 43% of non-IFC funding for its projects came from foreign and domestic government sources. In addition, IFC often invests in projects in which a government-owned entity dominates, especially in Sub-Saharan Africa. This requires close examination as to whether the expansion of IFC lending in Africa, and possibly other regions, would actually result in an expansion of private sector, or public sector activities.

3. Concentration of Investments in Low-Income Countries. The adverse global economic environment has brought to light many of the deficiencies in IFC's loan and equity program in low income countries lacking a private sector. New equity investments have stagnated over the past three years, loan arrearages have increased significantly; and the expected profitability of IFC equity investments has decreased. These portfolio problems raise issues of profitability, the degree of realism in the Plan, the relative regional sectoral priorities, etc. Although these problems could be alleviated by a shift back to more traditional geographic and sectoral priorities, the development focus of the Corporation, which mandates a presence in countries at the lower end of the income scale, must be maintained. The difficulty is in determining the balance which would allow the Corporation to operate in a financially efficient manner, while maximizing its developmental private sector focus.

4. Public Market Borrowings. Currently, IFC obtains its lending funds from the IBRD, which itself is experiencing an unprecedented demand by member governments for its scarce resources. As an alternative, IFC might borrow directly from public capital markets which would free up IBRD reserves and give IFC more flexibility in managing its investment funds. IFC does have the borrowing authority, but the market has never been tested. The IFC is currently preparing a study which will address the pros and cons of this issue.

5. Need for Capital Increase. The timing of IFC's need for new capital must be examined further. Since it can borrow four dollars for every dollar in paid-in capital, and currently has borrowed only about two, substantial lending capacity is still available. In addition, unused capacity for additional equity investment exists. Equity investment, which cannot exceed the amount of paid-in capital, presently only approaches one-third of existing capital. Although it has this authority, IFC's prudent financial practices prevent this. Because of the current investment

climate and IFC's poor income position, the Corporation feels it would be too risky to approach the limits of its borrowing and investment authority with the existing capital base. Therefore, the need and size of a capital increase must be evaulated in the context of what constitutes prudent operating ratios and how rapidly future growth will occur.

Conclusion

Before agreeing to the proposed capital increase, consultations within the U.S. Government, with the Corporation and with other members must be completed to resolve the outstanding questions previously mentioned. Any resolution would have to reconcile IFC's divergent roles as an investment corporation and development institution, and would have to settle or a future work program and level of capitalization which would maximize the IFC's role in enhancing commercial creditworthiness in developing countries while achieving the greatest financial impact with our scarce budgetary dollars.

October 4, 1983